6/4/81

Financial Markets

Irving Trust

Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research &
Planning Division

Friday
(Noon)

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Financial markets rallied impressively this week with rates all across the maturity spectrum posting sharp declines. Two key factors accounted for the change of sentiment: the recent slowing of a number of measures of price inflation and--more importantly--the sharply lower level of the Federal funds rate this week.

Yet the drop in the funds rate was scarcely unambiguous. On the one hand, the softening of the rate followed closely on the heels of the May 18 meeting of the Federal Open Market Committee, naturally fueling speculation that it reflected an overt move toward ease by the Fed. While that is a possiblity, it must be recalled that the Committee met against a background of very strong first-quarter GNP growth, coupled with a likely forecast by the staff that the relatively sluggish money growth during the first quarter would be offset by an acceleration during the current quarter. Moreover, we know from the minutes of the March 31 meeting that more weight is being given to growth of M-2--and that aggregate has been exceedingly strong recently.

A more plausible explanation for the recent softness is the Fed's severe underestimate of reserve availability in the banking system, most likely due to an unpredictable upsurge of Federal Reserve float during and following the Memorial Day weekend. This view is consistent with the softening of the funds rate that began last Friday and continued after the weekend, as well as the timing of the Fed's actions to drain reserves on Tuesday and Wednesday. Thursday's four-day reverse RP (which drains reserves) also seems to have been an aggressive move to arrest the decline of the funds rate in the current statement week, and the three-day reverse RP done today--when the funds rate had already moved up to 17 5/8% after opening at 17%--confirms the point.

Thus the rally of the last several days may be exposed to the loss of its main prop--the declining funds rate. Recall as well that the "effective" discount rate apparently has yet to reach 18%. With the basic discount rate at 14%, and the surcharge for large, frequent borrowers at 4%, the large banks have almost certainly been using up the four weekly "tickets" allotted to each of them to borrow during the calendar quarter at the cheap rate. That means that in coming weeks, more banks will be facing an 18% charge rather than 14%--a prospect with sinister implications for the ability of the market to trade Federal funds at levels around 17 1/2% as has occurred in the last few days. The prospects for a lower funds rate would naturally improve if hard evidence were to emerge of a major softening in the economy or--more critically--a continued slowdown of money growth, but thus far neither seems very likely near term.

William C. Melton

Note: The full text of the letter is available to Telerate subscribers on pages 7250-51 on the Monday morning following the Friday date of the letter.

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Market Yields

	5/29/81 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	20.50%	20.50%	14.00%
Effective since	5/22/81		
Discount Rate at Federal Reserve Bank	14.00	14.00	12.00
Federal Funds	17.50	19.50	11.00
Repurchase Agreements	16.00	17.25	8.25
U.S. Treasury Issues			
Bills			
3 months	16.11	17.69	8.20
6 months	15.61	17.04	8.55
1 year	15.16	16.41	8.90
Coupons			
2 years	14.68	15.45	9.15
4 years	14.25	14.70	9.70
7 years	13.78	14.10	9.95
10 years	13.54	13.82	10.20
Long Bond	13.13	13.36	10.30
Negotiable Certificates of Deposit-Secondary Market			
1 month	17.10	18.50	8.65
3 months	17.20	18.55	8.75
6 months	16.25	17.50	9.05
1 year	15.75	17.00	9.00
Banker's Acceptances			
1 month	17.25	18.60	8.60
3 months	16.95	18.60	8.70
6 months	16.35	17.70	9.10
Eurodollar Deposits			
1 month	18.00	19.25	9.50
2 months	18.00	19.25	9.75
3 months	18.00	19.31	9.88
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	16.50	18.00	9.00
1 month	16.25	17.75	8.00
3 months	15.75	17.00	7.75
Bank Holding Companies			
1 month	16.50	18.50	8.38
Dealer Placed:			
3 months	16.75	19.00	8.38
New AA Corporate Utility Bond	16.25	16.00	12.00
Tax Exempt			
6 month Project Notes	7.35	7.50	5.05
1 year AAA Bond	7.75	7.50	5.20
5 year AAA Bond	8.45	8.30	5.55
20 year AAA Bond	9.80	10.10	6.75

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

Cable Address:
"IrvingBank" Telex: I.T.T. 420268 • R.C.A. 232241
W.U.I. 62832 • French 82629